Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Runner | Analyst: Marion Mann DeJong | Bill Number: AB 2461

Related Bills: See Legislative History | Telephone: 845-6979 | Introduced Date: 02/24/2000

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: MIC/Change Costs to 8% & Extend to Mineral Extraction Activities & Allow Carryover Until Exhausted & Delete Repeal Date to Extend Indefinitely

SUMMARY

This bill would make the following changes to the Manufacturers' Investment Credit (MIC):

- increase the credit from 6% to 8% of qualified costs,
- include businesses extracting nonmetallic minerals in the definition of "qualified taxpayer,"
- allow unused credit carryovers to be carried forward indefinitely, and
- delete the repeal date.

EFFECTIVE DATE

The bill would take effect immediately upon enactment and specifies that it would apply only to taxable or income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 671 (Ch. 881, Stats 1993) added the MIC to the Revenue and Taxation Code. **SB 676 (Ch. 751, Stats. 1994)** made clarifying changes to the MIC. **SB 975 (Ch. 91, Stats. 1995)** was a code maintenance bill; it made technical changes to the MIC. **SB 38 (Ch. 954, Stats. 1996)** expanded the MIC by: (1) adding semiconductor equipment manufacturing and certain aerospace manufacturing to the definition of "qualified taxpayer" for the special purpose building provision; and (2) adding taxpayers engaged in certain biopharmaceutical and biotech activities to the definition of "small business." **SB 1106 (Ch. 604, Stats. 1997)** was a clean-up bill for SB 38; it made technical changes to the MIC. **AB 2798 (Ch. 323, Stats 1998)** extended the MIC to manufacturers of custom or prepackaged computer software. **SB 1229 (Ch. 987, Stats. 1999)** made clarifying changes needed as a result of AB 2798.

AB 2596 (2000) would, for taxable or income years beginning on or after January 1, 2000, allow unused MIC carryovers to be carried forward indefinitely.

SB 2145 (2000) would remove the repeal date and the manufacturing employment evaluation from the MIC, extending the credit indefinitely.

AB 473 (1999/2000) as introduced would have deleted the MIC repeal date. As amended June 23, 1999, AB 473 would extend the MIC repeal date to January 1, 2004. AB 473 is in the Senate Appropriations Committee.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
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AB 765 (1999) would have expanded the MIC to include specified activities related to extracting nonmetallic minerals described in Standard Industrial Classification (SIC) Codes 1411 to 1499. AB 765 was held in the Assembly Appropriations Committee and died pursuant to Joint Rule 62.

AB 648 (1997/1998) would have allowed unused MIC carryovers to be carried forward indefinitely. AB 648 was held in the Assembly Appropriations Committee.

AB 1062 (1997/1998) would have increased the MIC from 6% to 8% of qualified costs. AB 1062 was held in the Assembly Revenue and Taxation Committee.

SPECIFIC FINDINGS

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business.

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or for investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings, but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing state law allows taxpayers to use various credits against income tax such as the MIC. The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the SIC Manual. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of specified activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and (2) the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, including equipment used in the extraction process.

The MIC provides a variety of special rules for costs paid pursuant to a binding contract or to a lease of qualified property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover period is extended to ten years. The taxpayer must recapture any MIC previously allowed if the property is removed from California, disposed of to an unrelated party, or converted to an unauthorized use within one year from the date the property is first placed in service in California.

The MIC will become inoperative on January 1, 2001, or on the January 1 of the earliest year after 2001 if the total employment in manufacturing in this state does not exceed by 100,000 jobs the total employment in manufacturing in this state on January 1, 1994. The Employment Development Department (EDD) is required to report to the Legislature annually on this determination.

Certain "new businesses" (as defined) may claim an exemption from sales and use tax instead of this tax credit. The existing sales and use tax law also allows a taxpayer to claim a refund for the sales or use tax that was paid on the purchase of qualified property rather than claiming the MIC, subject to certain special rules relating to amount and timing of the refund.

This bill would make four changes to the MIC. First, this bill would increase the credit from 6% to 8% of qualified costs.

Second, this bill would include businesses extracting nonmetallic minerals in the definition of "qualified taxpayer." These activities are described in SIC Codes 1411 to 1499, inclusive, as follows:

- 141 DIMENSION STONE
  - 1411 Dimension Stone
- 142 CRUSHED AND BROKEN STONE, INCLUDING RIPRAP
  - 1422 Crushed and Broken Limestone
  - 1423 Crushed and Broken Granite
  - 1429 Crushed and Broken Stone, Not Elsewhere Classified
- 144 SAND AND GRAVEL
  - 1442 Construction Sand and Gravel
  - 1446 Industrial Sand
- 145 CLAY, CERAMIC AND REFRACTORY MINERALS
  - 1455 Kaolin and Ball Clay
  - 1459 Clay, Ceramic and Refractory Minerals, Not Elsewhere Classified
- 147 CHEMICAL AND FERTILIZER MINERAL MINING
  - 1474 Potash, Soda, and Borate Minerals
  - 1475 Phosphate Rock
  - 1479 Chemical and Fertilizer Mineral Mining, Not Elsewhere Classified
- 148 NONMETALLIC MINERALS SERVICES, EXCEPT FUELS
  - 1481 Nonmetallic Minerals Services, Except Fuels
- 149 MISCELLANEOUS NONMETALLIC MINERALS, EXCEPT FUELS
  - 1499 Miscellaneous Nonmetallic Minerals, Except Fuels

However, this bill does not modify the definition of qualified property. Thus, businesses related to extracting nonmetallic minerals would not be able to claim the credit since their property would not qualify for the MIC.

Third, this bill would change the MIC carryover provision from an eight or ten-year limited carryover to an unlimited carryover. Thus, for taxable or income years beginning on or after January 1, 2000, a taxpayer that is unable to use the entire MIC credit could carry over the credit indefinitely. However, carryovers from taxable or income years beginning prior to January 1, 2000, would continue to be limited.

Finally, this bill would remove the repeal date and the manufacturing employment evaluation from the MIC, extending the credit indefinitely.

Policy Considerations

This bill would raise the following policy considerations.

- When a general sales tax exemption for all manufacturing equipment proved too costly, the exemption was provided to only new manufacturers and the 6% MIC was enacted for other manufacturers. An 8% tax credit goes far beyond the 5% sales tax exemption.

- This bill may benefit transactions for which contracts already exist and would not be limited to benefit only future business decisions. Contracts in nonmetallic mineral transactions entered into after January 1, 1994, but prior to enactment of this bill, could qualify for the credit. Further, contracts entered into after January 1, 1994, but prior to enactment of this bill, would qualify for an increased MIC benefit (additional 2%).

- Recently, the policy regarding credit carryover provisions has moved from unlimited carryovers to limited carryovers, as most carryovers are used within eight years. This bill would reverse that policy.

Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- This bill did not modify the definition of qualified property to include property used in businesses relating to extracting nonmetallic minerals, nor did it remove the language that explicitly excludes equipment used in the extraction process. Further, the bill did not amend the types of qualified activities in which qualified property must be used in order to qualify for the MIC. Thus, taxpayers added by this bill would not qualify for the MIC under the bill as currently drafted. This may lead to disputes between taxpayers and the department, as well as not providing the intended incentive. According to the author’s staff, the bill will be amended to resolve these concerns.

- MIC carryovers from taxable or income years beginning before January 1, 2000, would continue to be limited. Taxpayers could misunderstand this law and try to claim credit carryovers that have expired. This may lead to disputes between taxpayers and the department. According to the author's staff, the bill will be amended to remove this provision, leaving the carryover provisions as in current law.

Technical Considerations

This bill would delete subdivision (i) and renumber subdivisions (j) and (k). Subdivisions (j) and (k) provide operative dates for changes made to the MIC since its original enactment. Since these subdivisions contain the phrase "the amendments made by the act adding this subdivision shall be operative" and this bill would renumber the subdivisions, taxpayers may have difficulty determining when the previous changes became operative. Amendments 1 through 4 would resolve this issue by referencing the specific laws that changed the MIC.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This revenue estimate assumes that the bill will be amended to reflect the author's intent to modify the definition of qualified property to include property used in business relating to extracting nonmetallic minerals.

Based on the data and assumptions below, revenue losses are estimated as follows:

Extending the MIC to Nonmetallic minerals and increasing the credit from 6% to 8% would result in the following revenue losses.

Revenue Impact of AB2461 For Taxable/Income Years Beginning 1/1/2000 Assumed Enactment After 6/30/2000 Fiscal Years (In Millions)			
	2000-1	**2001-2**	**2002-3**
Increase MIC to 8% Current Law	-$110	-$133	-$136
Add Nonmetallic To MIC:			
Under Current Law @ 6%	-$3	-$4	-$5
Increase MIC to 8%	-$1	-$1	-$1
Total Change to MIC	-$114	-$138	-142

Extending the carryforward period on credits generated after January 1, 2000, until exhausted would result in revenue losses in the $5 to $10 million range annually beginning in fiscal year 2008-09.

Eliminating the repeal date from the MIC would not impact current revenues. It is anticipated that the MIC will not sunset under the current law requirement. Under current law, the MIC will sunset only if employment in manufacturing, not including aerospace, on January 1, 2001, or any January 1 thereafter, "does not exceed by 100,000 jobs the total manufacturing sector employment in this state on January 1, 1994." Employment in manufacturing increased by 136,000 between 1994 and 1997. It seems safe to conclude that the targeted increase will be met and that the current law MIC will remain operative indefinitely beyond 2001. Thus, unless a major change in the economy occurs, eliminating the sunset date would not affect PIT or B&CT revenues.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Tax Revenue Discussion

This estimate is based on data from an U.S. Census Bureau survey of capital expenditures by relevant industries for 1997. The 1997 numbers were grown to approximate 2000 and beyond. The credit use rates taken from the microsimulation model of California tax returns were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on FTB's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2461
As Introduced February 24, 2000

AMENDMENT 1

On page 15, modify lines 2 and 3 as follows:

(i) The amendments made by ~~the act adding this subdivision~~ <u>Chapter 954 of the Statutes of 1996</u> shall be operative for taxable years beginning

AMENDMENT 2

On page 15, modify lines 7 and 8 as follows:

(j) The amendments made by ~~the act adding this subdivision~~ <u>Chapter 323 of the Statutes of 1998</u> shall be operative for taxable years beginning

AMENDMENT 3

On page 28, modify lines 8 and 9 as follows:

(i) The amendments made by ~~the act adding this subdivision~~ <u>Chapter 954 of the Statutes of 1996</u> shall be operative for income years beginning

AMENDMENT 4

On page 28, modify lines 13 and 14 as follows:

(j) The amendments made by ~~the act adding this subdivision~~ <u>Chapter 323 of the Statutes of 1998</u> shall be operative for income years beginning